

## *Marking Up to Market: Renewing Section 8 Contracts and the Problem of Owner "Opt Outs."*

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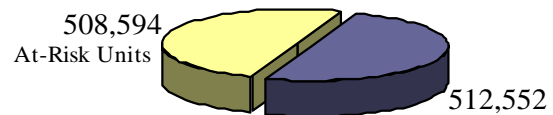
### Statement of the Problem

Owners of affordable multifamily housing projects subsidized through the federal "Section 8" program are, in increasing numbers, discontinuing their participation in the program and choosing to "opt out" upon expiration of their current Section 8 contracts. These increasing opt-outs could place thousands of residents, many of whom are elderly or persons with disabilities, at risk of losing their housing.

Section 8 opt-outs further erode the stock of affordable housing. Already Section 8 mortgage prepayments of federally-insured mortgages (the method by which a Section 8 project owner may terminate any affordability or use restrictions imposed on the property), have removed a substantial portion of units from the affordable housing inventory. In 1998, more than 345 properties with approximately 38,000 affordable housing units were removed from the Section 8

program as a result of both voluntary opt-outs by owners and HUD terminations. Through 2004, Section 8 contracts covering more than one million subsidized units will expire. Of these, more than 500,000 units of affordable housing may be at-risk of being lost due to opt-outs.<sup>1</sup>

#### Section 8 Units At-Risk of Opting Out



**Total Units Expiring Through 2004: 1,021,146**  
**At Risk Units: 508,594**

### The Section 8 Program

The Section 8 program (which gets its name from the provision of law in the United States Housing Act of 1937 which sets forth the requirements of the program) is the primary form of

<sup>1</sup> Testimony by the National Housing Trust before the Subcommittee on Housing and Community Opportunity, May 4, 1999, based on HUD Data compiled by the National Housing Trust.

direct federal housing assistance to low income Americans, serving more than 3 million families. By contrast, the public housing program serves approximately 1.4 million families.

The program provides subsidies in two forms: tenant-based assistance (Section 8 vouchers) and assistance to owners to develop and maintain Section 8 projects (project-based assistance). Tenant-based vouchers allow recipients the choice of where to use their subsidy, thus giving them the freedom to look for better housing in the private market. Vouchers empower residents with the ability to leave their current apartments and take their voucher with them. Because tenant-based assistance contains this facet of free-market competition, landlords must be more responsive to their tenants. By contrast, project-based Section 8 subsidy is tied to the actual housing development and units: individual tenants may leave, but the subsidy stays with those units for use by the next eligible low-income residents.

In its initial phases, the Section 8 project-based program provided 20-year contracts to owners and developers who would agree to house low-income families under HUD guidelines for the length of the contract. In many cases, private lenders provided the mortgage financing, also insured by the federal government through the Federal Housing Administration (FHA), for terms ranging from 40 to 50 years. As a consequence, the federal rent subsidies received by these Section 8 owners is a component of the total rental income used to pay the federally-insured mortgage.

For both the tenant-based and project-based programs, HUD establishes for each locality a rent level on which the federal government is willing to base its subsidy, known as the Fair Market Rent, or "FMR." Unfortunately, while FMRs are supposed to serve as the guideposts for setting subsidy levels, they are oftentimes a very poor reflection of the actual market rents for comparable units for the area. In some communities, FMRs are extremely low in relation to comparable "real" market rents.<sup>2</sup> For all practical purposes, project owners argue, the term is a misnomer in such cases in that FMRs are neither "fair" nor are they "market" in these areas. Instead, these artificial rent levels essentially serve as a form of federal rent control over the assisted housing inventory -- necessary as an upper limit on the federal government's financial exposure, but not necessarily an accurate portrayal of each market. Arguably then, for many areas of the country FMRs can be more accurately described as "fake market rents" rather than as true measures of local market realities

## Problems with Section 8

The combination of project-based Section 8 subsidies with long-term government-insured financing has led to a host of problems for the Section 8 program as local real estate markets and economic conditions change. Until recently the focus of concern from Congress and the Administration had been the Section 8 project-based properties with federal mortgage insurance which were receiving unit rents much *higher* than the FMRs for their localities. In some cases, their rents were higher than comparable rents.<sup>3</sup> For these "above market" Section 8 properties,

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<sup>2</sup> Appropriations acts have limited FMRs to 40% of the median rent for the locality.

<sup>3</sup> Primarily because certain cost adjustment factors built into the Section 8 contracts (Annual Automatic Adjustment Factors) ensured that contract rent levels would continue to increase, even though local real estate markets may have been experiencing a decline in private sector rent levels.

the federal government was paying more to house persons in the federal program than it would otherwise have cost in the private rental market.

The problem became critical at the time of contract expiration, when HUD had to choose either to renew such contracts or allow them to expire, thereby causing tenant displacement. Simply renewing these Section 8 contracts at their above-market rent levels would have been not only unwise policy, but unsustainable from a long-term budgetary perspective. The costs of pursuing such a policy would have been prohibitively expensive and would have eventually consumed all of HUD's budget authority. Unilaterally reducing the rents on these properties upon renewal and marking them down to market, however, would have triggered massive defaults on the federally-insured mortgages since many owners of these properties would have been unable to pay the debt service on these mortgages. Again, the federal government faced huge financial exposure through potential losses to HUD's FHA Multifamily Mortgage Insurance fund.

The 105th Congress attempted to address this dilemma when it passed the Multifamily Assisted Housing Reform and Affordability Act of 1997 ("MAHRA").<sup>4</sup> The legislation established a program to enable HUD to restructure and reduce the debt on many properties, enabling contract rents to be brought down to comparable market levels ("marked to market").

## **The Opt-Out Problem**

In contrast to the above-market portfolio, the Section 8 opt-out problem now confronting Congress involves *below-market* Section 8 projects. In many cases, the rents offered by HUD to the owners for renewal of their contracts is much lower than comparable rents for similar multifamily units in the locality. Upon expiration of a current contract, a private owner always has the right not to enter into a new contract with the federal government. By choosing not to renew and opting out of the program, such project owners can achieve higher rents for their units on the private market.

The temptation exists to characterize this as a problem of uncaring, greedy owners chasing higher profits without regard to the welfare of the tenants. In many ways, however, this portrayal is an oversimplification of the practical choices available to many of these owners. For example, many "owners" of Section 8 projects are business entities (such as limited partnerships), where legal and fiduciary obligations are imposed upon the party with management responsibility to maximize the return to the investors.<sup>5</sup> Federal tax law also plays a major role in determining the rational business choices available to any owner. Because of the way the tax code treats depreciation and what is considered taxable income from these properties, many owners face what is known as a "phantom income" problem (the IRS counts certain amounts as taxable income to the owner even though the owner does not actually receive such income in that year). As a result of the phantom income problem, some owners face severe cash flow problems and must increase revenues whenever possible. Because of such objective financial considerations, ascribing motivations such as "greed" to these owners is largely beside the point. After all, even

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<sup>4</sup> Title V of HR 2158, the VA, HUD and Independent Agencies Appropriations Act of 1998.

<sup>5</sup> In a limited partnership, for example, the general partner would have a fiduciary responsibility to operate the property and make financial decisions for the benefit of the limited partners.

an owner who is not motivated by greed is constrained if the choices are limited to opting-out, exposure to investor lawsuits, or bankruptcy.

In order to encourage (or enable) the owners of such projects to remain in the program, and prevent more opt-outs, many owners and housing advocates have called for HUD to renew expiring below-market Section 8 contracts at comparable market rents - a process known as "marking up to market." In fact, HUD has had the legal authority, and arguably the resources, to develop a comprehensive approach designed to mark up contracts upon their renewal. When Congress passed MAHRA it did more than just establish a program for dealing with above-market Section 8 properties. Section 524(a)(1) of MAHRA specifically affords HUD broad authority to renew expiring Section 8 contracts at rents that would not exceed comparable market rents for a locality.<sup>6</sup> Until recently, however, despite having the legislative authority and the current resources to address the issue, HUD had failed to offer or develop anything resembling a comprehensive approach to solving the opt-out problem.

Clearly, while the reasons for individual owner opt-out decisions may vary, the primary factor driving the increase in owners choosing to opt-out has been HUD's refusal to exercise the authority Congress provided in MAHRA to mark rents up to market. In fact, HUD Field staff has been extremely stringent in accepting and interpreting the results of rent comparability studies, provided by owners wishing to renew their contracts, that show market rents at higher levels than their current contract rents. This has been a particular problem in rural areas, where comparable rents may not be readily available. In some of these areas, for example, HUD has insisted on using as comparable rents the rent levels in properties funded through other federal programs (such as rural housing programs administered by the Department of Agriculture). Such rents are obviously not market – they are lower than market precisely because they are subsidized. In addition, many elderly developments were built in rural and depressed areas precisely because there was a severe need, and these projects are often the best housing available in such areas and more costly to maintain than the surrounding stock.

As noted earlier, depending on the underlying economic fundamentals of a particular Section 8 project and any legal or fiduciary obligations toward investors that may exist, an owner of these below-market Section 8 projects may have no choice but to leave the program. By refusing to mark contracts up to comparable market levels, many in the advocacy community and some legislators expressed belief that encouraging nonrenewals was an intentional policy choice.<sup>7</sup>

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<sup>6</sup> Section 524(a)(1) of MAHRA reads in pertinent part that ". . . the Secretary may use amounts available for the renewal of assistance under section 8 of the United States Housing Act of 1937, upon termination or expiration of a contract for assistance under section 8 (other than a contract for tenant-based assistance . . . ), to provide assistance under section 8 of such Act at rent levels that do not exceed comparable market rents for the market area. The assistance shall be provided in accordance with terms and conditions prescribed by the Secretary.

<sup>7</sup> In a letter to HUD Secretary Andrew Cuomo dated June 4, 1999, Senator Mikulski and Senator Bond wrote that the "failure of the Department to respond to the opt-out crisis has raised concerns that HUD is intentionally pushing owners to opt out with resulting loss of low-income housing and the displacement of tenants. This is most evident through the failure of the Department to use accurate appraisals to ensure that section 8 contracts can be renewed at a rent that reflects market conditions."

## The Voucher Option

When owners opt-out, the result is often undue hardship for many vulnerable tenants. While displaced residents are guaranteed housing assistance in the form of Section 8 vouchers, for a number of reasons this is not appealing for many Section 8 residents. A great number of those likely to be affected by opt-outs are elderly or disabled individuals, and have lived in these projects for long periods, oftentimes for the full 20 years of the original Section 8 contract. For the most part, being forced to move is extremely traumatic for these individuals, and preventing that necessity is their primary concern. Vouchers are perceived by other residents living in high-cost real estate markets to be ineffective in helping them finding adequate housing for their families. These elderly and disabled persons and families either do not want to move, or feel that if forced to move they will be unable to find adequate comparable housing. As a consequence, the appeal of vouchers that otherwise exists because of their free-market qualities and increased power of choice associated with them, eludes these particular individuals and families.

Moreover, HUD regulations governing the Section 8 program impose a requirement that vouchers be used only in properties with rents that are reasonable for the area for units of the same size and similar characteristics (so called “rent reasonableness requirements”). Because of this restriction, residents of a Section 8 project who receive vouchers as a consequence of an owner’s decision to opt out of the program may be precluded from using those vouchers in that project. For example, if an owner opts out and increases unit rents to \$500, but the HUD rent reasonableness guidelines are set at \$495, *then those receiving vouchers would not be allowed to remain in that project, even if they were willing to makeup the shortfall.*

Authority exists in current law for the provision of “enhanced vouchers” in certain circumstances. Enhanced vouchers (also know as “sticky” vouchers) provide a greater level of subsidy than ordinary vouchers, and are designed primarily to allow the resident to remain in the unit, despite the resulting rent levels exceeding allowable rents under the voucher program. These vouchers are only available for use in connection with mortgage prepayments, not in opt-out situations (unless the opt-out is also in connection with a mortgage prepayment).

While the vast majority of these elderly and disabled residents would rather remain in their homes, the overwhelming number cannot afford the likely rent increases. The following table shows the actual rent increases faced by residents in several projects located in rural Iowa where the owners opted-out of the program.<sup>8</sup> All of these projects served elderly residents:

Property Location	Number of Assisted Units	Average Tenant Monthly Income	Rent Before Opt-Out (per month)	Rent After Opt-Out (per month)	Rent/Percentage Rent Increase (per month)
Boone	56	\$650	\$195	\$299	\$104 (53%)
Knoxville	50	\$741	\$223	\$311	\$88 (39%)
Marshalltown	56	\$623	\$187	\$284	\$97 (52%)
Newton	56	\$700	\$210	\$351	\$141 (67%)
Pella	58	\$700	\$210	\$265	\$55 (26%)

<sup>8</sup> Information provided by the Iowa Coalition for Housing and the Homeless.

Opt-outs threaten some of the best affordable housing. HUD data shows that 90 percent of the subsidized units in properties whose owners say they are likely to opt out are located in low-poverty neighborhoods, where residents have access to greater employment opportunities, better schools for their children. In a rural area with little rental housing, these seniors may be forced to move long distances to find decent affordable housing.

Budget constraints have required annual contract renewals. While earlier long term-contracts meant that fewer opt-outs occurred each year, conversion to annual contracts mean that an owner has an opportunity to opt out each year. Residents, therefore, are constantly uncertain about the stability and status of their housing.

## Policy Responses

Because of the growing problem, several members of Congress who are key to housing legislation introduced bills designed to address the problem. On March 25, 1999, Banking Committee Chairman Jim Leach, Housing Subcommittee Chairman Rick Lazio, and VA/HUD Appropriations Subcommittee Chairman Jim Walsh introduced H.R. 1336, *“The Emergency Residents Protection Act of 1999”* to protect residents from displacement resulting from Section 8 opt-outs. Congressman Bruce Vento and Jim Ramstad introduced H.R. 425, *“The Housing Preservation Matching Grant of 1999”* on January 19, 1999, as a mechanism to foster the preservation of the affordable housing stock.

In light of these Congressional actions, HUD subsequently decided to reevaluate its existing renewal practices and issue new guidelines regarding Section 8 opt-outs. HUD Notice 99-15, the “Emergency Initiative to Preserve Below-Market Project-Based Section 8 Multifamily Housing Stock,” was issued on June 15, 1999.

HUD officials have given rough estimates regarding the financial resources needed by the Department under various approaches to the opt-out problem. According to HUD, renewing all below market Section 8 projects could eventually cost \$600 million to \$800 million dollars annually. HUD has also stated that using enhanced vouchers, it can prevent tenant displacement due to opt-outs this year at a cost of \$30 million in existing FY 99 resources, and would require \$77 million for FY 2000.

### H.R 1336    **THE EMERGENCY RESIDENTS PROTECTION ACT OF 1999**

The legislation expands existing authority for HUD to offer enhanced vouchers, providing assistance for rent levels up to the market level. Upon the death or change in residence of the tenant, the enhanced voucher either expires or converts to a standard voucher. The proposal expands the use of enhanced vouchers in more situations than allowed under current law, and targets the enhanced vouchers to seniors and persons with disabilities only. The legislation would allow enhanced vouchers for other low-income families at the discretion of HUD only in

low vacancy/tight market areas. The bill provides for enhanced vouchers subject to such sums as may be appropriated for FY2000-2004

H.R. 1336 mandates that HUD renew below-market expiring Section 8 contracts at no more than 90% of comparable market rents. The rationale for this provision was to circumscribe HUD's discretion so it actually renews contracts rather than allowing inaction to lead to more owner opt-outs. The 90% rent level was an initial figure provided by housing advocates and is likely to be modified as the legislation progresses.

## **H.R. 425      THE HOUSING PRESERVATION MATCHING GRANT OF 1999**

The approach in H.R. 425 emphasizes preservation of the housing units as affordable housing. The bill would authorize HUD to match state assistance for preservation of federally assisted affordable housing for low-income families. Many housing advocates argue that in addition to protecting the residents (by awarding enhanced vouchers, for example) any comprehensive approach to the opt-out problem must attempt to preserve the actual project itself in the affordable housing inventory. Otherwise, according to supporters of preservation efforts, offering additional enhanced voucher authority only may encourage owners not to renew their subsidy contracts.

H.R. 425 would match each dollar committed by a State for preservation efforts with two federal dollars. Grants can be used only for assistance for acquisition, preservation incentives, operating cost, and capital expenditures for housing projects that meet certain requirements set forth in the legislation. These requirements include mortgage financing through federally-insured programs, a binding commitment on the part of the owner (or subsequent owner) of the project to extend all low-income affordability restrictions, and a waiver of mortgage prepayment rights. The bill authorizes appropriations at such sums as necessary for these purposes.

## **HUD Notice 99-15      EMERGENCY INITIATIVE TO PRESERVE BELOW-MARKET PROJECT-BASED SECTION 8 MULTIFAMILY HOUSING STOCK.**

HUD Notice 99-15 (the "Emergency Initiative") provides instructions to HUD field staff, project owners and managers, on marking expiring Section 8 contracts up to market. An essential feature of the HUD approach is targeting of resources to those properties where opt outs are likely to occur, and where such opt-outs would result in undue harm to residents. HUD will target the properties most likely to opt out and will set a cap on the new rents that will be paid to project owners.

Market-level rents are to be determined by third-party market studies. HUD will mark rents up to market while limiting these increases in rents to a maximum of comparable market rents or 150% of the published FMRs. HUD's approach is not intended to prevent all opt outs, and the notice makes clear that only a portion of the stock will be preserved because of cost constraints and other factors. For those areas where opt-outs are not prevented, HUD has stated that additional enhanced voucher authority, like that provided by HR 1336, will be needed.



Properties are ineligible for rent increases under HUD's Emergency Initiative if:

- ☐ the mortgagor is a non-profit entity;
- ☐ the properties have a low- or moderate-income use restriction that will not be eliminated by the property prepaying or opting out of the Section 8 program (a project, for example, that is also a low income housing tax credit property);
- ☐ the property has a HUD Real Estate Assessment Center inspection score of less than 60;
- ☐ the owner is subject to administrative sanctions;
- ☐ the project is a Section 8 Moderate Rehabilitation project with a contract expiring in fiscal year 1999 (other than those assisted under Section 441 of the Stuart McKinney Homeless Assistance Act);
- ☐ the owner previously provided notice of an opt-out and the local housing authority has issued vouchers to one or more of the tenants; or,
- ☐ the project does not have a contract that is expiring.

In addition, criteria for participation in the program includes a requirement that the owner must have a "comparable gross rent potential" (defined in the Notice) at or above 110% of the fair market rent potential to participate in the program for certain properties. HUD's Assistant Secretary for Housing will have authority to issue waivers of certain eligibility requirements under certain circumstances (i.e where vouchers would be difficult to use in the local area, the residents are particularly vulnerable or the property is a high priority for the local community).

Contract renewals will be for five years, subject only to annual appropriations. Tenants will receive an initial notice describing the five-year contract. In addition, tenant notification requirements regarding expiration of the contract will be reduced from an annual requirement to a single notification six months before the end of the five-year period.

## Conclusion

A comprehensive approach is needed to protect residents threatened by displacement due to Section 8 opt-outs, and to preserve affordable housing where possible. H.R. 1336, H.R. 425, and HUD's recently issued Emergency Initiative offer somewhat different approaches to solving the opt-out problem. These various strategies are not necessarily mutually exclusive, however, and the most likely outcome is that aspects of each approach will be incorporated into bipartisan legislation that offers a variety of tools for addressing the issue.